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Before the

FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
Transfer of Control of Licenses MediaOne Group, Inc. to AT&T Corp.	)	CS Docket No. 99-251

SUPPLEMENTAL DECLARATION OF PROFESSOR JOHN C. COFFEE, JR.

Introduction

1. I make this supplemental declaration to address a question that has been raised in connection with the proposed acquisition by AT&T Corp. ("AT&T") of MediaOne Group, ("MediaOne"): What is the realistic nature of the economic relationship between AT&T and Liberty Media Corporation ("Liberty"), a Delaware corporation and AT&T's wholly owned subsidiary? For purposes of this analysis, it is understood and conceded that AT&T owns 100% of the stock of Liberty; that such stock is subject to the claims of AT&T creditors; and that such ownership entails real tax consequences, such as the membership of Liberty in AT&T's consolidated federal income tax group. Nevertheless, the issue remains whether AT&T can exploit this legal ownership of Liberty so as to derive any material economic benefit from that relationship. If it can, then it might well be in the interest of AT&T to seek to exercise control over Liberty. But if it cannot (which is the conclusion that I reach below), then AT&T lacks any

rational incentive to seek to dominate or influence Liberty. As detailed below, I find that the structure of the relationship between AT&T and Liberty effectively denies AT&T any realistic prospect of economic benefit from, and any ability to exercise control over, Liberty.

2. Because this declaration supplements another declaration of even date herewith in which I examined the level of influence and control that AT&T would have over Time Warner Entertainment Company, L.P., a Delaware limited partnership ("TWE"), by virtue of MediaOne's status as a limited partner in TWE, I will not again set forth my background and experience, which are detailed in that declaration, other than to state that I am the Adolf A. Berle Professor of Law at Columbia University School, where I specialize in corporate and securities law. In making this declaration, I am assuming that all the agreements and contracts referenced herein were duly authorized, constitute valid and binding obligations of the parties, and are enforceable according to their terms.

II. AT&T's Relationship with the Liberty Media Group

3. The special status of Liberty Media Group predates AT&T's 1999 acquisition of Tele-Communications, Inc. ("TCI"). TCI in fact had three distinct "tracking stocks": the TCI Group Tracking Stock, the Liberty Media Group Tracking Stock, and the TCI Ventures Group Tracking Stock. In preparation for the merger with AT&T, TCI combined TCI Ventures Group with Liberty Media Group and simultaneously consolidated their two tracking stocks into one. Thus, the resulting entity, Liberty Media Group, has been an independent business entity with its own tracking stockholders for some time, first as an independent business segment within TCI and now as a similar entity within AT&T. Under the Agreement and Plan of Restructuring and Merger by and between AT&T and TCI, dated June 23, 1998 (the "Merger Agreement"), a

wholly owned subsidiary of AT&T was merged into TCI, with TCI becoming a wholly owned subsidiary of AT&T (the "Merger"). As a result of the Merger, the assets and business of the combined AT&T/TCI entity were divided into two groups: (1) the "Common Stock Group," which consists of the assets of AT&T and TCI, other than certain of the assets previously held by either the Liberty Media Group or the TCI Ventures Group, and (2) the Liberty Media Group, which consists of the majority of the assets formerly held by the Liberty Media Group and the TCI Ventures Group. The former holders of the Liberty Media Group Tracking Stock and the TCI Ventures Group Tracking Stock received the Liberty Group Tracking Stock of AT&T, whereas the former holders of the AT&T Common Stock and the TCI Group Tracking Stock received AT&T Common Stock.

4. At the time of the Merger, a variety of intercompany agreements were entered into, and other protections were implemented, in order to ensure the independence of the Liberty Media Group. Before analyzing these agreements, it makes sense to begin with a short explanation of what a "tracking stock" is and what purposes it serves.

5. The idea of a "tracking stock" was pioneered by General Motors Corporation in the 1980's and has since been adopted by a number of large corporations, including USX Corp. (the former U.S. Steel) and Ralston Purina Co., as well as smaller high-tech companies, such as Genzyme Corp. The goal underlying the use of tracking stocks is to provide investors with the economic equivalent of an equity stock in an independent business entity or group of businesses, even though that entity or group remains owned by a diversified parent corporation, which itself issues the tracking stock. The alternative to a tracking stock is a spin off by the parent of the subsidiary or subsidiaries holding the assets that are to be separated from the parent. However,

tax and/or operational reasons often complicate any such complete separation and make the use of a tracking stock preferable. Although the goal of keeping the two business segments separate and independent requires careful tailoring of the dividend, voting, and liquidation rights of these two groups of shareholders, the Securities and Exchange Commission ("SEC") has repeatedly processed and declared effective registration statements relating to such transaction and has developed certain standard procedures. For example, the SEC has coined the term "group" and requires that each entity or group of businesses be collectively referred to as a "group;" it also specifies the nature of the financial statements that are to be provided to holders of the tracking stock. See Hass, Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness, 94 Mich. L. Rev. 2089, 2090-91, (1996).

6. Probably the most sensible way to analyze the various charter, by-law, and contractual provisions that are intended to protect the holders of the Liberty Media Group Tracking Stock is to focus on the various means by which a majority shareholder group could ordinarily seek to exploit, or expropriate value from, a separate class of shareholders in the same corporation. In overview, these techniques, while diverse, are likely to fall under one of the following general headings:

(1) Share Issuances: absent limitations, the dominant group could seek to issue additional shares of the minority class in order to either dilute the holders of the minority class or to shift voting control to the dominant group or some third party;

(2) Self-Dealing Transactions: through control of the AT&T board, a dominant group could conceivably seek to divert assets or funds away from the Liberty Media Group or enter into otherwise unfair or non-arm's length transactions that imposed

liabilities on the Liberty Media Group in order to benefit the Common Stock Group;

(3) Withholding Dividends: By refusing to pay out as dividends the profits earned by the Liberty Media Group, the dominant group might seek to force the Liberty Media Group shareholders into accepting some unfair alteration of their rights as the price of receiving any economic return; or

(4) Imposition of Disloyal Agents: If the dominant group could impose its own directors or officers on Liberty Media Corporation, it could then conceivably engage in low-visibility transactions that imposed either diverted assets or income from, or otherwise imposed unfair terms on, the Liberty Media Group shareholders, even if the contractual agreements or the charter documents mandated fairness.

Each of the possibilities will be considered in order below.

7. Share Issuances. All the outstanding shares in the Liberty Media Group were distributed to the former holders of the Liberty Media Group Tracking Stock of TCI on a one-for-one basis and TCI Ventures Group Tracking Stock on a 0.52-for-one basis. Moreover, AT&T cannot authorize additional Liberty Media Group Common Stock, or alter or change the powers, preferences, privileges, or special rights of such shares, without a special class vote of the holders of Liberty Media Group Common Stock. See Certificate of Amendment of the AT&T Certificate of Incorporation Under Section 805 of the Business Corporation Law, dated March 10, 1999, Article III, Part B, Section 1. (b) (i).

8. Although it remains possible (at least in theory) that AT&T could issue the authorized, but unissued, shares of the Liberty Media Group Tracking Stock in a manner that either diluted the existing holders of that class or conferred voting control over that class on persons whose real

interest was that of holders of the Common Stock Group, any such scenario runs into at least three major obstacles:

9. First, AT&T's Bylaws were specifically amended at the time of the Merger to provide for a Capital Stock Committee, which is to consist of Dr. John Malone, the former chief executive officer of TCI, and two independent directors, who may not be current or former officers or employees of AT&T or have certain other affiliations with AT&T. See By-laws of AT&T, as amended on March 1, 1999, Article VI. This committee is charged with the implementation of the policies set forth in the Policy Statement Regarding Liberty Media Group Tracking Stock Matters (the "Policy Statement"), which document was adopted by a resolution of a majority of the entire AT&T Board of Directors and imposes a standard of fair dealing on all transactions relating to the Liberty Media Group Tracking Stock. Not only would any scheme or artifice to violate this standard of fair dealing invite litigation, but, even more to the point, it is wholly unrealistic to imagine the Capital Stock Committee issuing additional shares of Liberty Media Group Tracking Stock -- except on terms that are scrupulously fair to the holders of that stock. Put simply, Dr. Malone has every incentive to resist any such unfair scheme and is ideally positioned to do so successfully.

10. Second, the proceeds of the issuance of any additional shares of Liberty Media Group Tracking Stock must be invested in Liberty. See Inter-Group Agreement between and among AT&T Corp. and Liberty Media Corporation and Liberty Media Group LLC, dated as of March 9, 1999, at Section 1.3(b). Thus, the proceeds of any such issuance cannot be distributed, directly or indirectly, to the holders of the Common Stock.

11. Finally, the ultimate weapon that precludes any such overreaching of the holders of the Liberty Media Group Tracking Stock is the Contribution Agreement by and among Liberty Media Corporation, Liberty Media Management LLC, Liberty Media Group, LLC, and Liberty Ventures Group LLC, dated as of March 9, 1999 (the "Contribution Agreement"). Under the terms of this agreement, if a "Triggering Event" occurs, then Liberty is required to convey and assign effectively all its assets to a separate entity, Liberty Media Group LLC, which is entirely separate from AT&T and cannot be controlled by it. Essentially, because the definition of "Triggering Event" includes any substitution of directors at Liberty that changes the control of its board, this in terrorem sanction effectively insulates the Liberty Board of Directors from any interference by AT&T or its shareholders. Indeed, even if it were possible for AT&T somehow to dilute the Liberty Media Group Tracking Stock, neither it nor its agents (nor frankly anyone else) could use that power to replace a majority of the incumbent directors of Liberty (or their chosen successors). Even the apprehension that such a control shift "is reasonably likely to occur" is deemed sufficient by the definition of "Triggering Event" in Section 1.1 of the Contribution Agreement to justify the contribution of Liberty's assets to Liberty Media Group, LLC, where they would be managed by a management group now headed by Dr. Malone.

12. Self-Dealing Transaction. It is even harder to imagine a realistic scenario under which the assets of Liberty could be expropriated by AT&T, or otherwise diverted to others, at unfairly low prices. Liberty will continue to be managed by its current management. Only the Liberty Board of Directors can change its management, and under Liberty's Certificate of Incorporation, a majority of its board of directors, who were directors or officers of TCI prior to the Merger, will remain in office for at least the first seven years. See Restated Certificate of Incorporation

of Liberty Media Corporation, Article V, Section B (providing for a staggered board of three classes with the term of the Class B directors expiring in 2006 and the term of the Class C directors expiring in 2009). Moreover, removal of Liberty's directors without cause is precluded by its Restated Certificate of Incorporation (See Article V, Section C). Although a removal for cause is necessarily permitted, the term "cause" is defined to "mean the conviction of a felony including moral turpitude." (See Article V, Section C). Even once it becomes possible to elect successor directors to replace these incumbent directors, the terms of the Contribution Agreement will still apply and authorize the "contribution" of Liberty's assets to Liberty Media Group LLC if the de facto control of the incumbent directors is ever overturned (or even reasonably threatened). As a practical matter, absent any judicial invalidation of the Contribution Agreement, AT&T is effectively forced in my judgment to elect directors to Liberty's board that are satisfactory to a majority of Liberty's current directors.

13. Beyond these negative sanctions that bar AT&T from interfering with Liberty's board structure, it is also necessary to remember that AT&T has bound itself in its Policy Statement to adopt and pursue a "fair dealing" policy in all inter-group dealings and has appointed a Capital Stock Committee (on which Dr. Malone sits) to implement that policy. See Policy Statement at Paragraphs 1(ii) and 2. Thus, whether one examines AT&T/Liberty relationship from the perspective of the AT&T side or from that of the Liberty side, the possibility for unfair self-dealing has been foreclosed from both sides, and more than ample safeguards have been erected.

14. <u>Withholding Dividends.</u> A standard technique for the exploitation or "oppression" of minority shareholders is to withhold dividends. Then, even if the minority has effective voting protections, they may agree to waive their rights in return for some economic return. But here,

AT&T possesses no such stranglehold over Liberty. The Liberty board of directors, which, as noted above, is beyond AT&T's control, can declare dividends from its earnings or capital, as it chooses. These dividends will, of course, go to Liberty Ventures Group LLC as its sole shareholder (which, in turn, is wholly owned by AT&T) but, at this point, AT&T is committed to pass through these dividends to the holders of the Liberty Media Group Tracking Stock. See Policy Statement at Paragraph 4.1. Under the terms of the judgment entered into by AT&T in the United States District Court for the District of Columbia in the TCI matter, "AT&T shall adhere to the Policy Statement Regarding Liberty Tracking Stock Matters contained in the Exhibit D to the AT&T/TCI Merger Agreement." Finally, any material modification to the policy statement would be publicly known and could invite litigation by the shareholders of Liberty Media Group Tracking Stock if they deemed the change to be materially adverse to their interests.

15. Appointment of Liberty Officers and Agents. If AT&T could appoint the officers or agents of Liberty, it might still be able to divert earnings or assets to the holders of its Common Stock Group. But AT&T is only a shareholder in Liberty (albeit the exclusive shareholder), and American corporate law does not empower a shareholder with the ability to appoint or remove corporate officers. Only Liberty's board of directors has this inherent power, and as already indicated the Liberty board is effectively independent -- both because of the three class staggered board that keeps a majority of pre-Merger Liberty directors in office until at least 2006 and, ultimately, because of the Contribution Agreement.

CONCLUSION

16. Based on the foregoing, I do not believe there is any realistic way that AT&T can dominate or control the Liberty board of directors, divert assets or earnings from Liberty to itself, or receive any material economic benefit from its ownership of Liberty. In turn, this implies that, having no economic incentive to control Liberty, AT&T should be rationally indifferent as to the management policies and practices that Liberty follows.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

John C Coffee Jr

John C. Coffee, Jr.

Executed on September 15, 1999

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AN ECONOMIC ANALYSIS OF THE EFFECTS OF THE AT&T-MEDIAONE MERGER ON COMPETITION IN THE SUPPLY AND DISTRIBUTION OF VIDEO PROGRAM SERVICES: RESPONSE TO THE CRITICS

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Introduction

In connection with the proposed AT&T-MediaOne merger, AT&T has asked CRA to respond to claims made by a number of economists retained by parties opposed to the transaction. These claims focus on the allegedly adverse effects the combination would have on competition in the supply and distribution of video program services. We first show why claims that the merger will dramatically increase concentration in the supply of program services are incorrect. Among the major flaws in the analysis of economists who make such claims is their treatment of the AT&T-MediaOne merger as if it were accompanied by a complete merger of the economic interests of AT&T, MediaOne, Cablevision and Time Warner. Once this and other conceptual flaws are corrected, the change in concentration resulting from the AT&T-MediaOne merger is a fraction of that claimed by opponents. For these and other reasons, we find that the merger is likely to have little effect on competition among program services.

We further explain why the claim that DBS places no significant competitive constraints on cable system pricing is incorrect. Indeed, it appears that DBS is a potent competitor to cable and that the current market share of DBS substantially understates the significance of this competitive threat. This threat not only increases the alternatives that are available to consumers but it also reduces whatever power large cable MSOs may have over cable program services.

We next take up the issues of monopsony power and vertical foreclosure. In analyzing the ability of an MSO to obtain anticompetitive concessions from program services or to foreclose rival services, the only relevant systems are those for which the MSO buys programming or controls or influences programming choices. Obviously, an MSO derives no power to force concessions from program services based on cable systems for which it plays no role in programming choices.

In analyzing the claim that the merged entity will be able to exert monopsony power in purchasing programming, we conclude that the effect of the merger on program service pricing is likely to be small. We also explain why the competitive threat of DBS, as well as competition from over-the-air broadcasters, reduces the ability of large MSOs such as AT&T to exercise monopsony power. In addition, we make clear why, even if AT&T possesses bargaining power in its dealings with program services, there is likely to be little or no effect on the quantity or quality of programming available to MVPD subscribers.

Next, we analyze the claim that large cable MSOs receive inefficiently large discounts when they purchase cable programming. We conclude both that the evidence for the claimed magnitude of these discounts is weak and that substantial discounts can be justified by the efficiencies involved in selling to large MSOs.

We then examine the claim that large vertically integrated MSOs in general, and the merged AT&T-MediaOne in particular, will attempt to foreclose rival program services. We begin by summarizing the empirical evidence on foreclosure by vertically integrated cable operators and conclude that this evidence is not consistent with a pattern of foreclosure, even by the largest vertically integrated MSOs. We then explain that there are many factors tending to offset any incentives that any large MSO might otherwise have to engage in foreclosure, and we describe how these factors support the conclusion that AT&T is unlikely to have either the incentive or ability to foreclose rival programmers. In addition, we explain why the growth of DBS serves to attenuate further the ability of AT&T to foreclose rival program services.

Besides greatly overstating the increase in concentration that would result from the AT&T-MediaOne merger, the opposing economists completely ignore the associated efficiency gains. As a result, they greatly overstate the risks and understate the benefits of the merger. In sharp contrast, throughout our analysis, we identify these efficiency gains and describe the corresponding benefits the merger will produce for MVPD subscribers.[1]

Concentration in Program Services

In its report to the Commission, the Consumer Federation of America (CFA) asserts that AT&T's acquisition of MediaOne will result in a substantial increase in concentration in the supply of program services.[2] CFA reaches this conclusion by assuming that the AT&T-MediaOne merger is effectively a complete merger of AT&T, MediaOne, Cablevision, and Time Warner (including Time Warner Entertainment). Based on this flawed assumption, CFA calculates that the increase in the Herfindahl-Hirschman Index (HHI) of concentration[3] in the supply of program services resulting from the AT&T acquisition of MediaOne is about 1200, raising the

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[1] The efficiencies discussed in this paper are those that affect the supply and distribution of video program services. Merger-related efficiencies in the supply of telephone and broadband services are discussed in the accompanying Declaration of Janusz A. Ordover and Robert D. Willig.

[2] Consumers Union, Consumer Federation of America, and Media Access Project (CFA), *Breaking the Rules* (hereafter *Breaking the Rules*), pp. 52-55.

[3] The HHI, which is generally accepted by economists as a measure of concentration for the purpose of evaluating horizontal competition, is equal to the sum of the squared market shares (measured in percentage terms) of all the firms in an industry. The HHI ranges from near zero, when there are many firms with very small shares, to 10,000 under monopoly.

HHI to a level exceeding 2500, a level that the *Horizontal Merger Guidelines* (issued jointly by the Federal Trade Commission and the U.S. Department of Justice) would characterize as highly concentrated.[4] On this basis, CFA concludes that the merger, "given the level of concentration in the industry, should be challenged."[5]

CFA's implementation of the HHI grossly distorts the effect of the merger on concentration in the supply of programming to MVPDs. For example, in its calculations, CFA assumes that AT&T's one-third ownership interest in Cablevision is equivalent to *complete* ownership and control of Cablevision by AT&T. This assumption exaggerates the effect of the merger on concentration because it overstates the market share of AT&T.

CFA's approach effectively assumes both that AT&T would capture 100% of the benefits that accrue to Cablevision if AT&T program services were to compete less aggressively, and that AT&T could also compel the program services affiliated with Cablevision to compete less aggressively with AT&T's affiliated program services. In fact, AT&T's interest in Cablevision's program services is only 33%; thus, AT&T could capture only 33% of the benefits from its actions, not 100%. In addition, AT&T's financial interest conveys little if any control over the operations of

[4] CFA calculates an industry HHI that is slightly under 2500 based upon total subscribership to program services, but the HHI calculation does not include the shares of all service providers, Exhibit 11, p. 54.
[5] *Breaking the Rules*, p. 54.

Cablevision that could be used to compel the Cablevision program services to compete less aggressively.[6]

In a similar, but even more distorting, manner, CFA implicitly assumes that AT&T's acquisition of MediaOne completely merges the economic interests of Time Warner and AT&T. Although the acquisition does provide AT&T with a financial interest in Time Warner Entertainment (TWE) (approximately 25%), that interest is significantly less than the 100% interest effectively assumed by CFA.

In addition, according to a recent Form 8-K filed by TWE, as a result of the proposed acquisition, "MediaOne's governance and management rights have terminated immediately and irrevocably to the fullest extent permitted by... the TWE Partnership Agreement."[7] Our understanding is that, as a result, AT&T will have no relevant control over the actions of TWE management. [8]

Equally important, the acquisition does not increase AT&T's interest in the Time Warner program services that are held outside TWE, most importantly the Turner services (for example, CNN, TNT, and the Cartoon Network). By contrast, CFA's methodology implicitly assumes that, as a result of the merger, AT&T will acquire a 100% financial interest in, and complete control of, these services.

CFA's calculations also assume that AT&T has a 100% financial interest in, and complete control over, Liberty, which, in CFA's view, houses the various program service interests "owned" by AT&T. However, we understand that, under

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[6] AT&T has a 33% ownership share in Cablevision, but only an 8.9% voting share. Moreover, as described in AT&T's and MediaOne's Public Interest Statement (p. 12), the Dolan family exercises virtually complete control over Cablevision's operations.

[7] Securities and Exchange Commission Form 8-K, Current Report, August 3, 1999, Time Warner Entertainment Company, L.P.

[8] *See* Declaration of Professor John C. Coffee, Jr.

the terms of the Liberty tracking stock, AT&T shareholders cannot receive any increase in profits experienced by Liberty, and that AT&T lacks effective control over Liberty's behavior.[9] If so, then Liberty behaves more like an independent firm than a subsidiary of AT&T.

Finally, even if it had correctly implemented the HHI, which it has not, CFA fails to consider other factors that reduce the competitive significance of a high HHI. In particular, entry into the program services market seems relatively easy; in the last two years alone, the number of new services offered totaled 98.[10] We are also unaware of any significant legal or regulatory barriers; in fact, the Commission has promulgated a number of rules designed to ensure that programmers have the ability to obtain distribution from unaffiliated MSOs. Finally, it is our understanding that many cable systems are upgrading their capacity and, as a consequence, will need to purchase additional programming.

In what follows, we provide a method for accounting for AT&T's partial ownership interests in other program services without assuming that a partial ownership interest, no matter how small, provides AT&T with 100% of the profits and complete control of the "acquired" firm. In this way, we develop a more appropriate and sensible framework for evaluating the effect of AT&T's proposed acquisition of MediaOne on concentration in the supply of program services to MVPDs and, using this framework, we show that this effect is small.

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[9] *See* Supplemental Declaration of Professor John C. Coffee, Jr.

[10] Federal Communications Commission, *Fourth Annual Report In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CS Docket No. 97-141, Released January 13, 1998, para. 158; and *Fifth Annual Report In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CS Docket No. 98-102, Released December 23, 1998 (hereafter "Fifth Annual Report"), para. 159.

Accounting for Partial Ownership Interests

As the previous discussion suggests, it is important to distinguish the *financial interest* the investor has in a firm — roughly speaking, the share of the firm's profits that are due the investor — and the *control* over the behavior of the firm conveyed by the financial interest. Specifically, the implications of a financial interest for horizontal competitive concerns depend upon 1) whether the financial interest conveys control of the firm in which the investment has been made (the "acquired" firm), 2) the size of the financial interest, 3) the competitive significance of the investor, and 4) the competitive significance of the acquired firm.

An Interest Resulting in Complete Control

If a program service acquires a partial ownership interest in another service that effectively permits the former to control the latter, an argument might be made that the investing entity has the same ability to control the acquired firm as under a complete merger. However, even in this case, the incentives for the investor to take actions that may benefit the acquired firm will be less than under a complete merger because the investor obtains less than a 100% share of the profits of the acquired firm. Thus, even in this case, one should treat the acquisition of the ownership interest as being different from a complete merger.

A Silent Financial Ownership Interest

A silent financial ownership interest in a program service is one that does not afford the investor any control or influence over the management of the acquired program service. Thus, although the investor may alter its own behavior as a result of the acquisition of the interest, it *cannot* directly affect the behavior of the acquired service. Although silent financial interests are often small, even a large interest can be silent if it is accompanied by (for example) binding commitments to insulate management from control by the investor.

Ownership Interests That Convey Partial Control or Influence

Finally, managers may respond to owners with large financial interests by accounting for the effects of their managerial decisions on the profits of owners that do not exercise direct control. For example, managers may believe that their job security or compensation is at risk if they take actions that adversely affect the profits of one or more owners with large financial interests. In this case, control of the firm is partial, because the extent of control of any individual owner depends on the magnitude of its interest, the magnitude of the interests of other large investors, and the source of profits of other large investors. Control of the firm is indirect, because it relies on managers having the incentives to serve the interests of large investors without explicit direction.

However, the extent of this "indirect" control should not be overstated. In fact, it may not exist at all in many situations. Partial ownership may not result in meaningful control because of the threat of shareholder suits, or by increases in the cost of capital, that might arise if the managers ignore the interests of other shareholders. The more conflicting are the various ownership interests, the more likely is management to focus on maximizing the value of the firm as a stand-alone entity.

Evaluating the Competitive Significance of a Financial Interest When the Firms Are Horizontal Rivals

Consider a circumstance in which one program service acquires a minority ownership interest in a rival service that conveys less than complete control. Because the acquired firm and the investor compete, the intensity of price competition may be reduced (ignoring entry, the effect of other competitors, and other relevant market responses that may affect price competition). This occurs because, if the investor competes less aggressively, the profits of the acquired firm will rise and the investor will share in the higher profits by virtue of its financial interest. In addition, if the interest conveys some control, the acquired firm will also compete less aggressively, further increasing the profits of its investor.

However, the extent to which these incentives actually manifest themselves in reduced competition depends on a number of factors. A larger financial interest in the acquired firm yields a larger incentive to compete less aggressively (because the acquirer captures a greater share of the higher profits experienced by the acquired firm). The larger is the market share of the acquired firm, the greater is the increase in the profits of the acquired firm when the investing firm competes less aggressively. The greater is the market share of the investor, the greater is its profit when the acquired firm competes less aggressively. The greater the control conveyed by the financial interest, the larger would be the effects on suppressing competition. Finally, the more closely aligned are the interests of all owners, the larger may be the anticompetitive effect from the financial interest.[11]

[11] For example, in the case of partial control, if other minority investors with partial control are also rivals of the acquired firm, the price effects will be increased because all investors benefit from reduced price competition.

Measuring Market Concentration

The previous discussion highlighted the complexity of a complete evaluation of the competitive significance of a financial interest acquired by one firm in another. In this section, we apply the principles discussed above to analyze the effect of the AT&T-MediaOne merger on concentration in the supply of program services. In this regard, we present a metric to measure the effects of an acquisition of a partial ownership interest by one program service in a rival. The metric takes into account the market share of the acquiring firm, the share of the acquired firm, the shares of the other firms in the industry, and the size of the acquired ownership interest. . We stress at the outset that, if anything, our analysis is highly conservative because it ignores the effect of entry, the effect of other competitors, and other relevant market responses that may effect price competition.

The Modified Herfindahl-Hirschman Index

One way to account for the effects of partial financial interests is through a more refined construction of the concentration index than the mechanical approach taken by CFA. We are aware of only one index that does so in any rigorous way: the modified Herfindahl-Hirschman Index, or "MHHI."[12]

The MHHI recognizes that three factors are important for measuring concentration: ownership, control, and market shares. Like the HHI, the index places greater weight on firms with larger shares. In addition, the index properly accounts for how partial ownership interests affect incentives.

[12] *See* T.F. Bresnahan and S.C. Salop, "Quantifying the Competitive Effects of Production Joint Ventures," *International Journal of Industrial Organization* 4 (1986): pp. 155-175. The theoretical underpinnings of our MHHI analysis is set forth in Appendix A.

In one case of concern — a silent financial interest — the MHHI is simple to calculate. If firm A takes a silent financial interest of α% in firm B, and the firms have no other partial ownership interests, the MHHI is calculated as:[13]

$$\text{MHHI} = \text{HHI} + (\alpha/100) \times S_A \times S_B$$

where S_A and S_B are the market shares of firms A and B, respectively, and HHI is the measure of concentration if there were no overlap in ownership among firms. That is, prior to firm A's acquisition of a partial interest in firm B, the MHHI is equal to the HHI. The effect of firm A's acquisition of a partial interest in firm B is thus to raise the ordinary HHI by an amount equal to the fractional partial ownership interest times the share of firm A times the share of firm B.

A simple way to think about the MHHI in the context of evaluating the competitive significance of silent interests is as follows: Absent any partial ownership interests, the MHHI is equal to the standard HHI. If firm A takes an α% interest in firm B, the MHHI increases by $(\alpha/100) \times S_A \times S_B$.[14] If firm A had instead merged with firm B, the HHI would have increased by $2 \times S_A \times S_B$.

A numerical example helps illuminate the difference between the HHI, which is appropriate for 100% ownership interests, and the MHHI, which is appropriate for partial ownership interests. Suppose that firms A and B each have 30% market shares. If firm A merges with firm B, the HHI increases by 1800 (= 2 x 30 x 30) points. However, if firm A takes a 5% silent financial interest in firm B, the MHHI

[13] *See* Appendix A.

[14] If firm A acquired a 50% silent financial interest in firm B and firm B acquired a 50% silent financial interest in firm A, the MHHI would rise by the product of the two shares. Because the interests are silent, the increase in the index would still be smaller than in the case of a merger of the two firms (in which case the index would increase by twice the product of the two shares).

rises by only 45 (= .05 x 30 x 30) points. In this example, treating a 5% silent financial interest as a complete merger would overstate the impact of the acquisition on concentration by 4000%!

The above example assumes that the partial ownership interest is silent, i.e., non-controlling. An alternative assumption is that the control or "influence" that an owner has over the manager of the firm in which it has a partial ownership interest is proportional to the owner's partial interest.[15] More precisely, one can assume that the manager of a partially owned firm maximizes a weighted average of the owners' profits, where the weight given to each owner's profits is equal to its ownership interest. The MHHI makes it possible to account for ownership this way. (See Appendix A.) However, as we observed above, the ability of managers to act in this way is limited by the threat of shareholder suits, among other factors.

Calculating the MHHI

We have calculated the MHHI in the supply of program services under alternative assumptions about the extent to which AT&T controls and has a financial interest in Liberty and about the nature of the financial interest in TWE acquired by AT&T as a result of the merger.

Case 1 assumes that AT&T and Liberty are completely separate entities, while Case 2 assumes that Liberty is fully owned and controlled by AT&T.[16] In both

[15] In the spectrum of control possibilities between a financial interest that is silent and one that conveys complete control, there are many possible ways to characterize the effect of partial control. Depending upon the particular interest acquired, whether there is another owner with a larger interest that is effectively controlling, the size of the interests of the other major investors, the significance of public shareholders, and other factors, the extent of partial control may be more or less than proportional.

[16] Although these are natural cases to consider, we understand (as noted above) that the actual relationship between AT&T and Liberty is much closer to Case 1.

cases, we assume that all owners of a program service exercise proportional control over the management of the service (i.e., their voting shares are equal to their ownership shares), with some significant exceptions. We understand that Liberty's 9% financial interest in Time Warner and its 8% interest in News Corp. are non-voting and therefore are treated as silent. For reasons discussed previously and in the Public Interest Statement, we also assume that AT&T's 33% financial interest in Cablevision is silent. Finally, we treat AT&T's interest in TWE as silent after the merger.

Cases 3 and 4 are similar to cases 1 and 2, respectively, except that MediaOne's interest in TWE is assumed to convey proportional control after the merger, although, for reasons already discussed, we believe that this substantially overstates any control that AT&T may have. In all cases, our analysis includes 61 basic program services and 9 premium services.[17]

As reported in Table 1 (attached to the end of this report), the AT&T-MediaOne merger increases the MHHI by only 48 if Liberty is treated as separate from AT&T, and by only 104 even if Liberty is assumed to be completely controlled by AT&T. (See cases 1 and 2 in Table 1.) This is about one-tenth of the size of the change estimated by CFA. Moreover, while CFA calculates a post-merger level of concentration in excess of 2500, the more appropriate calculation here indicates that the post-merger MHHI is only slightly above the "moderately concentrated" threshold of the *Horizontal Merger Guidelines*. This conclusion is little changed

[17] This is the universe of services for which revenue data were available. See the sources listed in Appendix B.

even in cases 3 and 4, where AT&T is assumed to have proportional control of TWE after the merger. Indeed, if Liberty is assumed to be separate from AT&T, the change in concentration is even smaller where control of TWE is assumed to be proportional.[18] In any event, the competitive effects of these small increases in concentration, even if they were empirically important, could likely be easily offset by the entry of new program services (including additional services from existing providers). Moreover, as noted above, this MHHI analysis overstates the competitive impact of the merger. Barriers to entry into the programming market are low.

In addition, the calculations reported in Table 1 fail to account for other sources of programming that compete with MVPD program services for the patronage of consumers. These sources would include broadcast television, movies for theatrical release, and pre-recorded videocassettes. For example, inclusion of revenues from the sale of videocassettes in the MHHI analysis (which accounts for the financial interest of MVPD program service owners in the sale of videocassettes) would result in post-merger MHHIs below 1800 for all cases, with a maximum change in the MHHI of 87, i.e., within the Horizontal Merger Guidelines "safe harbor" for moderately concentrated industries.

[18] It may seem surprising that if Liberty is treated as an independent firm, the change in the MHHI is larger when, post-merger, MediaOne's interest in TWE is largely silent (Case 1 vs. Case 3 in Table 1). This occurs in this calculation because, after the merger and as a result of the merger, Time Warner will now have effective control over TWE. If MediaOne's interest in TWE becomes silent after the merger, Time Warner will have full control of TWE. As a result of the merger-induced increase in Time Warner's control of TWE, Time Warner will have a greater ability to make the TWE services compete less fiercely against the Turner services (in which Time Warner has a 91% ownership share). This is reflected in the larger MHHI change in Case 1 versus Case 3. Of course, as noted in the text, all of the MHHI changes are relatively small.

Summary

CFA assumes that the AT&T-MediaOne merger is also a merger between AT&T and TWE and between AT&T and Time Warner. As a result, CFA attributes a substantial change in program service concentration to the AT&T-MediaOne acquisition. However, because AT&T's acquisition of a partial ownership interest in TWE is not equivalent to a merger among AT&T, TWE, and Time Warner, the CFA approach greatly overstates the competitive significance of the merger. The more appropriate accounting of partial ownership interests conducted here reveals that, in fact, the change in concentration is only a small fraction of that estimated by CFA and presents little competitive concerns.

The Effect of Competition from DBS

In his Declaration, Professor Hausman asserts that cable systems exercise unconstrained market power. In particular, Hausman claims that the competitive check afforded by DBS and other wireless providers to cable system pricing is not competitively important.[19] This assertion appears to be driven largely by two putative "facts." First, Hausman claims that while DBS prices have been falling, cable prices have been rising.[20] Second, Hausman claims that the lower cable prices in those franchise areas that have two rival cable systems demonstrate "the lack of an effective price constraint by DBS."[21]

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[19] Declaration of Jerry A. Hausman Filed on Behalf of SBC, August 23, 1999 (Hereafter "Hausman Declaration"), pp. 3-5. *Breaking the Rules*, p. 50, makes a similar claim when it contends that the FCC's decision to include DBS in calculating market concentration "is not justified."

[20] Hausman Declaration, p. 4.

[21] *Id.* Hausman also asserts that DBS's inability to carry local stations and its high upfront costs deter consumers from purchasing DBS. However, both DirecTV and EchoStar offer consumers the

With respect to the first claim, it is notable that the FCC observes that some of the cable rate increase "is attributable to capital expenditures for the upgrading of cable facilities, an increase [sic] number of video and non-video services offered, and increased programming costs."[22] It is not altogether surprising that cable service prices have increased to reflect increases in the costs and quality of the services that are offered. At the same time, the Commission quotes the Strategis Group as finding that "[DBS] equipment costs have spiraled downward," which explains much of the DBS price reduction.[23]

With respect to the second claim, it is unremarkable that the entry of a second cable system in any particular franchise area would reduce MVPD prices. Prior to that entry, the local supply of MVPD services might have been shared (for example) among the local cable operator, DirecTV, and EchoStar. In these circumstances, the entry of a fourth provider could have the effect of lowering prices charged by all providers, including the DBS rivals. The fact that cable prices are lower in overbuilt areas does not preclude the possibility (one that we regard as likely) that the presence of DBS constrains cable prices in all areas, whether overbuilt or not.

In contrast to Hausman's view, most knowledgeable observers have concluded that DBS is a significant rival to cable systems. Indeed, the Antitrust Division of the Department of Justice recently concluded:

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option of purchasing an over-the-air antenna as part of the dish. In addition, the Fifth Annual Report, para. 73, notes that upfront costs have been declining rapidly.

[22] Fifth Annual Report, para. 47.

[23] *Id.*, para. 73.

> Cable and DBS are both MVPD products. While the programming services are delivered via different technologies, consumers view the services as similar and to a large degree substitutable. Indeed, most new DBS subscribers in recent years are former cable subscribers who either stopped buying cable or downgraded their cable service once they purchased a DBS system. Cable and DBS compete by offering similar packages of basic and premium channels for a monthly subscription fee.[24]

Similarly, the Federal Communications Commission has observed that:

> DBS continues to represent the single largest competitor to cable operators and DBS subscribership continues to show strong growth. The four DBS providers furnished programming to more than 7.2 million subscribers as of June 1998. This is an increase of more than 2.2 million subscribers since June 1997, or nearly 43%. In addition, industry reports state that 2.2 million of the 3.6 million net new MVPD subscribers in 1998, or almost two thirds, are choosing DBS. The Strategis Group projects that DBS subscribership will grow to 20 million by 2003, with its share of the multichannel video market growing to 25%. *SkyReport*, a trade publication that tracks DBS subscriber growth, estimates that DBS will have 15.2 million subscribers by 2002.[25]

As the above quotation suggests, while DBS imposes a significant constraint on cable system pricing behavior, the competitive significance of DBS is understated by its current market share because DBS has been growing very rapidly.

The very rapid growth in DBS subscribership in recent years, the virtually ubiquitous coverage of DBS operators, and analyst projections for near-term DBS growth all indicate that the video marketplace cannot be analyzed without considering the substantial impact of DBS on cable system behavior. As we emphasize below, the entry and growth of DBS have not only provided additional alternatives to subscribers but have also reduced whatever power large cable

[24] *United States of America v. Primestar, Inc. et al.*, filed in the United States District Court for the District of Columbia, May 12, 1998, para. 63.
[25] Fifth Annual Report, para. 62, footnotes omitted.

MSOs have over program services. In particular, by increasing the number and importance of alternatives to cable, the growth of DBS has reduced the ability of AT&T and other large MSOs to exercise monopsony or engage in vertical foreclosure. This would be true even if cable and DBS served completely distinct sets of subscribers. For example, although MSOs in Canada do not compete with those in the US, they still provide an outlet for much of the same video programming that appears on U.S. cable systems.

The Issue of Monopsony

In his Declaration, Hausman asserts that a large cable operator can unilaterally exercise monopsony power against program services.[26] According to Hausman, a large cable operator can extract lower prices from the program services by threatening not to carry the service, thereby reducing the revenues of the program service. Hausman thus concludes that "if a cable channel receives below the competitive price for its programming or receives lower advertising revenues, it will have an economic incentive to decrease the quality of its product and spend less on content creation."[27]

Hausman also asserts that this same leverage will permit the large MSO to demand an "ex post [ownership] share... in successful cable packages," an outcome that will again "lead to a reduction in investment and lower quality cable offerings."[28] Hausman then goes on to assert that the merged AT&T will certainly

[26] Hausman Declaration, pp. 8-11.
[27] *Id.*, p. 9.
[28] *Id.*, p. 11. As discussed in greater detail with respect to AT&T's incentive to foreclose rival program services, a large MSO's threat not to carry popular services such as MTV, ESPN, or CNN is simply not credible because failure to carry such services would likely result in a significant decline in

be sufficiently large to exercise such leverage. Even if AT&T alone cannot exercise that power, Hausman claims that AT&T in coordination with other large MSOs can collectively exercise that leverage. Hausman (and CFA) provide estimates of the size of AT&T and of concentration in cable system ownership as support for this alleged harm.

Hausman is incorrect for a number of reasons. First, AT&T currently and after the merger is unlikely to possess monopsony power. Importantly, AT&T's purchases of program services likely account for a relatively small share of the market in which the services compete for inputs, and will continue to do so even after the merger.

Second, Hausman (and CFA) overstate the size of AT&T and the effects of the merger on coordination among MSOs in exercising monopsony power by assuming that a partial ownership interest in cable systems is equivalent to complete ownership and control of those systems by the owners of the partial interest.

Finally, even if AT&T did have the ability to exercise monopsony power, it would not likely be exercised in a way that resulted in fewer or lower-quality program services. Indeed, a larger MSO may have an incentive to pay *higher* program service prices (other things equal) than a smaller MSO in order to ensure

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subscribership, including subscribers who would switch to DBS. Thus, the threat could only be credible against less popular program services. However, many such services seem to have survived and thrived with penetration rates that are quite modest. For example, FiT TV is on systems serving only 14.1% of all MVPD subscribers and Eye on the People is on systems serving only 13.8% of all MVPD subscribers. (Data are from the Fifth Annual Report.) For these services, the threat is also not likely to be credible because non-carriage will not result in their demise or in a significant quality reduction of the services.

that the number and quality of the program services are not diminished by "free-riding" by smaller MSOs on the payments made by larger MSOs. In other words, the AT&T-MediaOne merger may lead to greater efficiency in the market for program services by reducing the extent to which the quality and variety of the program services are "public goods." In what follows, we explain why the circumstances in which monopsony power can lead to consumer harm by reducing the quantity or quality of program services are highly unlikely to be realized in the sale of program services.

<u>The Hausman-CFA Approach to Measuring AT&T's Subscriber Share Is Flawed</u>

As the merging parties noted in their Public Interest Statement, the post-merger AT&T will purchase programming for only about 27%[29] of MVPD subscribers. The subscriber control they provide to AT&T is significantly less than the 35% threshold specified in the *Horizontal Merger Guidelines*.

Professor Hausman disagrees with this measurement of AT&T's size. According to Hausman, the financial interests that AT&T has in other cable systems will apparently facilitate tacit coordination among MSOs for the purchase of program services:

> Given that the economic interests of cable MSOs coincide on many economic issues, such as achieving low programming costs from third party providers, direct control is not required for cable MSOs to decide jointly to bargain together, or at least to take similar negotiating positions when bargaining with outside suppliers. Thus, affiliated cable MSOs should be considered in the competitive

[29] Public Interest Statement, p. 55.

analysis of the merger, rather than limiting the analysis only to cable MSOs that are directly controlled by the merged company.[30]

Whatever incomplete inferences regarding the exercise of monopsony power that might be drawn from the pre- and post-merger size of AT&T have been completely distorted by Hausman (and by CFA). Hausman implicitly assumes that any cable system in which AT&T has as little as a 5% ownership interest should be treated the same as a system that is totally owned and controlled by AT&T. Using this approach, Hausman estimates that AT&T will have a post-merger MVPD subscriber share of about 48%[31], as opposed to a 29%[32] share if only subscribers to systems directly controlled by AT&T are counted (or 27% if only subscribers for whom AT&T purchases programming are counted). CFA apparently follows a similarly flawed methodology and reaches a similar conclusion.

Hausman also uses this methodology to assert that, nationwide, the HHI in the sale of services to MVPD subscribers will increase by nearly 1100 points[33] as a result of the merger. Using homes passed by cable systems (i.e., ignoring DBS subscribers), CFA asserts that the HHI will rise by over 1200 points.[34] According to Hausman, this increase in the HHI will significantly increase the likelihood that MSOs will be able to present a united bargaining front in negotiations with program services.

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[30] Hausman Declaration, p. 7, footnotes omitted.
[31] *Id.*, p. 7.
[32] *Id.*, p. 6.
[33] *Id.*, p. 7.
[34] *Breaking The Rules*, p. 54.

The approaches adopted by Hausman and CFA grossly distort any inference about changes in monopsony power that one might be able to draw from the changes in the "size" of AT&T as a result of the merger. First, Hausman's approach requires that the price that AT&T pays to (say) MTV is linked to the price that a partially affiliated cable operator pays for MTV. But cable operators do not "compete" with each other in the purchase of programming. This is because a sale by MTV to one operator does not preclude the sale of the same service to a second operator. Thus, there is no necessary linkage between the price MTV obtains from one operator and that obtained from another.

Such a linkage could occur if all cable MSOs explicitly bargained jointly, as Hausman suggests, but in fact there is no such joint bargaining. It is not at all apparent what "tacit joint bargaining" means, or how it could achieve an outcome similar to that for explicit joint bargaining. For example, if AT&T bargained aggressively with a program supplier, the price charged AT&T might be lower than otherwise. But Hausman never explains how a second MSO would benefit from the bargain obtained by AT&T and, therefore, how AT&T's acquisition of a silent financial interest in the second MSO would result in AT&T becoming a more aggressive bargainer.

Even if we assume that any lower price AT&T obtains would benefit other cable operators, the Hausman and CFA approach is flawed because it treats a partial financial interest by AT&T in other MSOs as equivalent to a merger between AT&T and those MSOs. In effect, this approach implicitly assumes that the competitive significance of a 5% financial interest by AT&T in another MSO is equivalent to that of a 100% interest in the same MSO. Yet, the incentives for AT&T to take actions that benefit the other MSO are not independent of the size of that financial interest. The larger the financial interest, the greater the incentive for AT&T to act in a way that benefits the other MSO. For the reasons stated more fully above, the approach of treating the two interests as equivalent, and both as equivalent to a full merger, defies both economic and common sense.[35]

Moreover, in order for a large MSO to use its buying power in a way that adversely affects viewers, it would have to decline to carry some program services that would otherwise be profitable to carry, or compel a reduction in its program quality, and the effect would have to be to reduce the prices at which other program services could be purchased. In the standard monopsony analysis, a single purchaser faces an upward-sloping supply curve, i.e., as the quantity supplied increases, the cost of supplying additional quantities also increases. In these circumstances, additional purchases increase the price paid for all units purchased. Thus, the purchaser recognizes that the cost to it of purchasing additional quantities of the input includes not only the price paid for those additional units, but also the increased payment on all other units purchased. For this reason, the monopsonist restricts the amount purchased. By contrast, if there were many small buyers, each would ignore any effect of its purchases on prices because its individual purchases would have a negligible effect on price and, thus, all buyers together would purchase more than would a monopsonist.

[35] A more appropriate accounting for these partial financial interests yields a change in the MHHI of at most about 380 and a post-merger MHHI of at most about 1450, well within the *Horizontal Merger Guidelines* characterization of a "moderately concentrated" industry. (See Table 2 and Appendix C.)

There are a number of reasons to believe that AT&T will lack the ability or incentive to reduce the prices paid for programming in a way that restricts the supply of programming. First, available evidence does not indicate that increased purchases of program services will result in substantial increases in program services' input costs during any medium or long-term time horizon.[36] The rapid expansion of the number of program services that has occurred during the space of only a few years suggests a relatively elastic supply of many of the inputs that are used by program services.[37]

Second, and related to the first point, program services compete with other purchasers for the inputs used to produce the services. Thus, the services compete for inputs (writers, directors, actors, etc.) with suppliers who create programs for television broadcast stations (first-run syndication) and networks, with the movie studios in the production of first-run theatricals, and with live theatre, among others. Thus, in this broader market, AT&T's purchases are likely to have little or no effect on price.[38] That is, AT&T would perceive the relevant program service supply curve to be quite elastic.

Third, as discussed extensively above, DBS provides an increasingly important alternative outlet for program services. As a result, the ability of any large

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[36] Put somewhat differently, over these time periods, the relevant antitrust market is not likely to be limited to those inputs used in producing specific types of program services.

[37] There were 147 national cable program networks at the end of 1996 and 245 at the end of 1998. The sources for this calculation were those provided in footnote 10.

[38] One (somewhat imperfect) indicator of AT&T's relative unimportance in this broader input market is its share of the revenues of downstream providers using these inputs. MVPDs account for about 40% of the combined revenues of MVPDs, broadcast networks and stations, theatrical motion pictures, and videocassettes. Even if AT&T accounted for 50% of all MVPD revenues, it would account for only 20% of revenues of all purchasers of programming inputs.

MSO, including AT&T, to bargain successfully for below-competitive prices from the program services has correspondingly diminished. Indeed, this would be true even if DBS and cable systems had completely distinct and non-competing subscriber bases because DBS and cable systems offer their respective subscribers the same programming.

Finally, even if AT&T increases its demand for services and the service supply curve is upward-sloping, it might still be able to pay the higher price only for the *additional* services, without causing the prices of the other services to increase. If this were the case, then the monopsony would not result in fewer services being purchased.

Some cable program services have higher costs than others, and demand, and receive, higher fees from cable operators. Those higher costs, in turn, may reflect the higher quality of those cable services. So long as paying for a higher-cost service does not increase the price that must be paid for a lower-cost service, AT&T has no incentive to restrict its purchases in order to exercise market power. Thus, large MSOs may be able to limit the prices they pay for some program services without having to restrict their purchases.

Bargaining over the price of program rights and program inputs is a common phenomenon throughout the video, entertainment, and sports industries. Some programming and sports events, and, in turn, some of the talent responsible for such programming and sports events, generate revenues in excess of the value those inputs could generate in their next-best use. In other words, such programming and inputs into programming generate revenues in excess of the minimum costs that must be paid to command their use. That means there is room for bargaining between buyer and seller over the difference between the minimum amount the seller must be paid and the maximum amount the buyer would pay.

There is little room for bargaining over fees for program services that generate an increment in revenue to cable systems only slightly larger than the costs of the program service, where those costs are the minimum amounts the service could pay and still purchase rights to its programming.[39] Significantly, however, the amount paid by a single large buyer such as AT&T for one program service is unlikely to affect the price it pays for all other services. Thus, for example, a perfectly price-discriminating monopsonist would pay only the minimum amount necessary for each program service, an amount that would be unaffected by the number or identity of other program services that it purchases. In the more realistic case, in which AT&T shared rents with program services, it could avoid having the bargaining over the rents for one program service affect the prices it pays for all others.[40] In any event, the exercise of bargaining power would not affect the identity or quality of programming that is offered.

Professor Hausman asserts the contrary. He claims that by virtue of its buying power, AT&T can force a supplier that has already incurred sunk entry costs, i.e., an established supplier, to accept a price so low that it will cause the

[39] This does not imply that license fees would be the same for all such marginally profitable services. The levels of costs and of incremental revenues could, and probably do, vary substantially across such services.

[40] Even where it is in the joint interest of the cable system and the program service to have the cable system carry the service, one can imagine the program service posturing for a larger share of the rents. In these cases, it is possible that some "mistakes" will be made, and the carriage of some services may be delayed.

supplier to incur losses over the lifetime of the service (Hausman's "holdup" contention). However, at least with respect to the supply of program services to MVPDs, this kind of behavior is unlikely to be empirically important. If AT&T were to engage in such opportunism, the quality of programming available to it would decline over time and it (and other MVPDs) would experience a reduction in profits. The loss in future profits deters AT&T from engaging in such behavior.

In fact, the potential for bargaining power to reduce the amount of programming supplied might be greater if all cable MSOs were smaller. A small MSO is less likely to consider the effect of price paid on the survival of the program service, or on the quality of programming, since the license fee it pays will generally be too small to have a substantial effect on the program service.

Taking the contract with a single small MSO in isolation, the program service is better off selling rather than not selling so long as the revenue received covers the *incremental* cost of supplying this small MSO. However, if many small MSOs could force the program service to accept less than the *average* cost of supplying them, the supply of programming could be restricted.

AT&T will be constrained in its bargaining, in a way many small MSOs would not, by the knowledge on the part of both MSO and program service that the total costs of the program service must be covered.[41] Thus, there is a significant constraint on the exercise of bargaining power by AT&T.

[41] In addition, as pointed out below, being able to deal with larger MSOs may reduce the transaction costs of arranging the buying commitments that program services may require in order to begin offering new services and to make substantial quality improvements in existing services.

Summary

Both before and after the merger, AT&T is not likely to be able to wield monopsony power. The measures of market concentration on which Hausman and CFA rely for inferring AT&T's ability to exercise monopsony power, and the conceptual basis for the inferences themselves, are flawed and are therefore not a valid indicator of the effect of the merger on either the incentive or ability of AT&T-MediaOne to exercise that power. In addition, the program services purchased by AT&T and other MVPDs compete for inputs in a much broader market with broadcast television and theatrical movies and the purchases of program services by AT&T account for only a small fraction of the input sales in this broad market.

Finally, even if AT&T had the ability and incentive to exercise monopsony power, it would not, in contrast to what Hausman suggests, likely pay a price for a service that would cause that service to be unprofitable. Such behavior would discourage the development of the critical inputs — programming — required by AT&T (and other MVPDs). Thus, any bargaining power AT&T might have would not lead to a reduction in program output or quality. Moreover, after the acquisition of MediaOne, AT&T will have an increased incentive to encourage the development of program services.